

Portfolio performance

The Swell Global Portfolio increased by 18.02% in the six months to June 2021, outperforming the MSCI world index by 1.82%. Market disruption caused by the pandemic in the six months to December 2020 has now largely abated, with

investors returning to quality stocks, reversing the trend of the prior six months. We made some substantial changes to the Portfolio in the half, selling four holdings and adding five new companies. As of June 30, the Portfolio held 15 stocks.

Market conditions

Inflation expectations increased rapidly during the second half of FY21 as economic conditions improved and fears over the pandemic subsided. The vaccination campaign in developed countries contributed to market enthusiasm driving short term interest rates higher leading to a rotation from high quality companies into lower quality businesses with greater leverage to the economic reopening. The US and Europe are making solid progress with their vaccination programs while Australia continues to languish. These countries have lowered movement restrictions and their economies are beginning to normalise. Unfortunately, the delta strain of SARS-CoV-2 is beginning to assert itself within countries with high levels of vaccination, and being 50% more infectious than the alpha variant, its spread may lead to further restrictions on economies in coming months.

We believe the effects of inflation will be transitory, ensuring debt rates remain historically lower. Productivity gains, the large amount of debt outstanding and demographic headwinds will all place downward pressure on interest rates. We expect worker productivity to improve as businesses digitise, allowing wages to rise and productivity gains to offset labour shortages. While many market participants lean on the yield curve to draw conclusions about the direction of equity markets, we do not believe the shape of the yield curve is signalling, predominantly due to the significant amount of government intervention.

ESG

At Swell, our investment philosophy requires us to approach investing from a fundamental bottom up perspective. We seek to own concentrated positions in high quality companies that have favourable long term prospects and strong management teams. We also require these companies to adhere to environment, social and governance (ESG) standards.

In April this year Swell became a signatory to the UNPRI and this means we will publish our voting annually. ESG has always been an important component of our investment process and it closely aligns with our long term focus. As part of our commitment we are excluding several sectors from our investment universe including companies involved in the

production and distribution of tobacco products, pornography, production and distribution of gambling products, weapons manufacturing, fossil fuel mining and production, energy generation based on fossil fuels, uranium mining and nuclear energy.

Portfolio Investments

During the half we sold Apple, Bank of America, JP Morgan Chase & Co, and Starbucks.

Apple had been in the Portfolio since its inception in 2015, and although it is always a hard decision to sell a quality business, it had reached our valuation and accordingly our investment process required us to sell.

The banks were sold for a different reason. We purchased Bank of America in 2017 and JP Morgan in 2020 following our review of their competitive position, specifically the investments they are making in technology. However, we believe the threat posed by fintech companies and neobanks as they expand their businesses in payments, credit card receivables and other core banking services represents a significant risk to the traditional banks.

Starbucks has been a holding since 2017, and like Apple was sold on valuation grounds. We continue to monitor these companies and will consider them again on any share price weakness.

We added Intel, Netflix, Shopify, S&P Global and Zillow to the Portfolio.

Our top three investments in the half were Alphabet, Facebook and Microsoft. We discuss each company below.

Alphabet

Alphabet's March quarter income rose 32% year on year to \$55.3 billion, with Search up 30%, YouTube up 49%, network ad revenue up 30% and other revenue up 46%. The integration of Fitbit, which was finalised in January, added 1,800 employees during the quarter, together with nearly 3,000 additional engineers and product managers. CEO Sundar Pichai told investors on the earnings call the company was continuing to develop AI enhancements to its apps and services including recommended routes on Maps to reduce carbon impacts, and

indoor live Map views using augmented reality for venues such as airports and shopping malls.

The US Supreme Court ruled in favour of Google in its 10-year copyright dispute with Oracle over use of Oracle's Java API in Android software. Oracle had sought \$9 billion for Google's use of 11,500 lines of code from the Java API developed by Sun Microsystems, which Oracle acquired in 2010.

The Court ruled "(Google's) new product offers programmers a highly creative and innovative tool for a smartphone environment. To the extent that Google used parts of the Sun Java API to create a new platform that could be readily used by programmers, its use was consistent with that creative "progress" that is the basic constitutional objective of copyright itself."

Google announced major updates at its annual I/O event from 18 - 20 May, clarifying for investors where the company is focusing its investments and strategic R&D spend. The event demonstrated a clear leadership in AI technology that will expand Google's competitive advantage in many of its business segments.

- Google Search is transitioning to a new model, called Multi-task Unified Model (MUM), that is 1000x more powerful than the existing BERT search model. MUM combines text, image, video, and other mediums to enable more complex, nuanced, and conversational searches across 75 languages.
- Google Maps has integrated augmented reality (AR) features for both indoor and outdoor navigation. Maps now covers more than 60 million kilometres of roads, 1 billion buildings and 150 million local guides.
- Google Shopping connects people with over 24 billion listings from millions of merchants. An expanded partnership with Shopify will seamlessly integrate the two platforms for Shopify's 1.7 million merchants.
- Google previewed an AI-powered tool to identify skin conditions from photographs taken with a smart phone.

Researchers from Cornell University, in partnership with Google, reported this month a deep learning system was able to detect tuberculosis from chest x-rays as accurately as radiologists. The technology could save up to 80% of the cost of treating the more than 10 million annual cases of TB.

Facebook

Facebook's income in the March quarter rose 44% from the same quarter in 2020, to \$26.17 billion. Average revenue per user increased across the globe, from \$6.95 in the previous quarter to \$9.27, and other revenue experienced a significant rise from \$297 million to \$732 million, driven by Oculus Quest 2 sales. This continued the trend identified in the December quarter, when other revenue rose a massive 156% on Q419 to

\$885 million, led by Oculus Quest 2 sales, with both the CEO and CFO claiming the VR (Virtual Reality) device was a "hot" holiday gift.

CEO Mark Zuckerberg believes the company's investment in augmented and virtual reality will be game-changing, noting "If you look at the history of computing, every 15 years or so a new major platform emerges that integrates technology more naturally and ubiquitously into our lives — starting with mainframes, then PCs, then browser-based computing, and then mobile. I believe that the next logical step here is an immersive computing platform that just delivers this magical sense of presence — that you're really there with another person or in another place."

Facebook acquired BigBox VR, the studio which created the popular game Population: One released for the Oculus Quest 2. The game, considered a VR clone of Fortnite, allows up to 24 people to connect, play and compete in a virtual world. A trial of ads inside Oculus headsets is underway, starting with the shooter game Blaston and two other apps. Advertising revenue should drive developer interest and content creation while supporting further investments in VR/AR. Developers and users are being encouraged to provide feedback on the ads to guide future, broader advertising plans.

New tools for creators to monetise content on Facebook's platforms through advertising and subscriptions will further develop revenue streams. Between 2019 and 2020 the number of content creators on the platforms earning 0the equivalent of US\$10,000 per month grew by 88%, and in-stream advertising payments increased 55% in the sa147me period. The introduction of Stars provided an additional revenue stream for content creators, with more than US\$10 million per month generated for creators in the six months to March 2021.

The collaboration and communication software, Workplace reached 7 million paid subscribers in May, an increase of 40% over the same period last year. While it represents a small portion of the company's overall revenue, Workplace highlights the potential Facebook has to leverage its network and expand revenue streams beyond advertising.

Microsoft

Microsoft's Q3 revenue, to March 2021, grew 19% year on year to \$41.7 billion, with cloud revenue up 33% to \$17.7 billion. CEO Satya Nadella told investors the increase in digital adoption identified in 2020 had continued to accelerate through the first three months of 2021.

A new employee experience platform called Microsoft Viva will provide tools for employee engagement, learning, wellbeing, and knowledge engagement and integrate directly with current workflows in the Microsoft 365 and Microsoft Teams environments. Announcing the platform, Mr Nadella said

"Every organisation will require a unified employee experience from onboarding and collaboration to continuous learning and growth. Viva brings together everything an employee needs to be successful, from day one, in a single, integrated experience directly in Teams."

Microsoft partnered with electronics manufacturer Foxconn to accelerate its smart manufacturing and hybrid workplace. Foxconn will utilise Microsoft's Azure AI and database services as part of the digital transformation of its manufacturing processes and Microsoft 365 to increase workplace flexibility.

Microsoft will supply the US Army with 120,000 mixed-reality headsets based on its HoloLens over the next ten years. The devices use an Integrated Visual Augmentation System (IVAS) which has been developed over the three years Microsoft has been working with the Army. The headsets will allow soldiers to see through smoke and around corners, use holographic imagery for training and have 3D terrain maps projected onto their field of vision. The contract will be worth more than \$20 billion.

Later this year Microsoft will complete its acquisition of Nuance Communications, an AI software developer of natural language interfaces and speech recognition for various industries including the medical field. The deal received US antitrust approval in June. Nuance was a pioneer in speech recognition technology with its Dragon software which was famously used to power early versions of Apple's Siri. Dragon is used by 70% of US hospitals, 75% of radiologists, and 80% of Fortune 100 companies and will be integrated into Microsoft's healthcare cloud platform.

2021 Outlook

From a global perspective we expect an uneven recovery with markets with high levels of vaccination rates outperforming markets with limited access to vaccines. The latest strain of COVID is a stark reminder that the pandemic is not over.

Many of the companies whose sales were impacted by the pandemic last year have now lapped their weakest quarters and have signalled their year-on-year earnings growth rates will decelerate in the second half of 2021. Despite the fact that some companies might be experiencing peak earnings growth, it is important to point out that we are not talking about negative growth rates. We believe valuations are appropriate when assessed against a 10 year treasury yield of c1.5%.

In terms of digital transformation, we believe we are still in the early stages of a shift that will impact every business. In the near-term companies driving this change including Microsoft, Amazon, Facebook, Google, PayPal, Shopify and others will continue to benefit from increased demand for their products while they simultaneously invest heavily in R&D and growth CAPEX to take advantage of the long-term opportunity.

In a low growth world it is important to be exposed to companies that can grow their earning irrespective of the macro economic environment. Our portfolio of high quality companies are uniquely positioned to benefit from digitisation and resilient enough to respond to the pandemic.

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